The Federal Income Tax Policy:
An analysis of the 1995 reformation proposals

An Honors Thesis (HONRS 499)

by

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Abstract

This paper outlines the findings of a study of the current proposals to change the Federal Income Tax Policy. The current system has been proven to be ineffective. With the 1996 election year approaching, this topic is of great importance. Each presidential candidate will be pressed about his or her views on what changes need to be made to the tax policy.

It is important to understand the issues the candidate supports in order to make an informed vote. The purpose of this paper is to outline the main aspects, advantages, and disadvantages of each proposal.

The issues behind determination of a good tax are presented. Then, the Flat Tax, VAT, USA Tax and NST are studied in detail. The methods studied provide a range of income and consumption based methods.

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Introduction:

As we approach the presidential election of 1996, a major issue of concern is the problems with the Federal Tax Policy. The current income based system is criticized for its discouragement of savings and investment, inequity among class levels, complexity of rules and regulations, and accessibility to evasion (Pechman, 70).

Reasons to study the Federal Tax Policy:

Congress has modified the current tax system 31 times in the past 41 years and it is still ineffective. The Internal Revenue Service (IRS) has admitted that it fails to collect from nearly 10 million taxpayers netting an estimated $217 billion uncollected. In addition, the current system through double taxation of savings and investments has resulted in a 1992 national savings rate of 1.1% as compared to an average of 9% in the 1960's. Thus, capital to fuel the economy has become increasingly scarce (Lugar, 2).

The annual productivity gain has also declined from 2.9% (pre-1974) to 1.1% (1974-1994). The Concord Coalition estimates that had the productivity held the annual 2.9% rate, the median family income would now be $50,000 a year instead of the current level of $35,000 a year (Lugar, 2).

The tax policy affects everyone through its collection and its uses. In theory, everyone pays his/her fair share of taxes. In return, each person is allowed to utilize government funded public services. Federal taxation is a necessary means of governmental funding of these public services namely: parks, highways, social services, education, national defense, and many others.

The goals of federal taxation are as follows:

1. transfer resources from the private to the public sector
2. fairly distribute the cost of governmental activities among people in approximately the same economic circumstances
3. promote economic growth, stability, and efficiency (Pechman, 5).

How exactly the government is to obtain these funds while obtaining its goals is a topic with diverse views. Proponents of change profess the need for a better measurement of "ability to pay" along with a system that lessens governmental intervention into private decisions through a consumption tax. The main debate, therefore, is whether federal taxation should be based on income or on consumption. Often that discussion commences with what constitutes a good tax.

What constitutes a good Tax?

Adam Smith in his book <u>The Wealth of Nations</u> set forth a list of taxation criteria. They include: equity, neutrality, certainty of incidence, certainty of liability, certainty of the evasion ratio, certainty with which the authorities can predict the revenue that will fall due within a given period; evidence to the taxpaying public; administrative efficiency; and net revenue restraining effect. These criteria are complex, yet, still respected today (Utz, 19).

Former Chairman of the Senate Finance Committee, Senator Bob Packwood, revised Adam Smith's complex criteria for evaluating an effective tax system. Senator Packwood states the criteria as follows: (1) simple, (2) the least intrusive, (3) fair, (4) border adjustable, and (5) friendly to savings and investment. One of the most difficult and most important criteria to meet, according to Senator Packwood, is a system that is fair (Lugar, 3). The focus of this study will be on which method of taxation provides a fair impact on diverse individuals.

What constitutes fairness in taxation?

Congress sets criteria for determining whether taxpayers are the same or are different in economic terms. The purpose is to treat individuals in the same economic position with the same tax burden, "horizontal equity". In addition, the tax treatment of differently-situated persons (vertical equity) denotes the view that the rich should pay more taxes than the poor. Although "unlike" individuals are presumed to be taxed differently, tax fairness postulates only that the different tax liabilities should be a function of the different tax bases. This concept is termed "ability-to-pay" (Dodge, 88-89).

The ability-to-pay measurement attempts to provide substance to the equal-sacrifice principle. Each taxpayer's burden would produce an equal sacrifice regardless of income level. It is necessary to evaluate the "real" burden or incidence of the tax as opposed to the nominal burden to be borne by a person occupying a given position (Utz, 41-45). For this reason, ability-to-pay plays a major role in the evaluation of the proposed tax methods.

The current income and consumption based proposals will be examined.

The Income Based Method of Taxation

An income based method of taxation taxes individuals on some measurement of their income. Currently, taxable income equals the taxpayer's total gross income less certain exclusions, exemptions, and deductions. Graduated tax rates are then applied to the taxpayer's taxable income to determine his/her tax liability.

The argument for using an income based tax is ability-to-pay. It is hypothesized that the higher a person's income, the higher his/her ability to pay the tax liability. The many exclusions and credits are to compensate for the diverse demands on that individual's income. Thus the income tax is aimed at disposable income. Disposable income is the portion of income available to spend on items void of necessity. The exclusions provide for the necessities; the disposable income is for items of luxury and should be taxed.

The current income based method discourages savings and investment because interest and dividends are taxed as income. This, in turn, negatively affects the economy. Additionally, the current system favors individuals in debt since borrowed income is excluded from the tax base. This has also been proven detrimental to the U.S. economy (Lugar,3). Proposals to change to a different income based method have consequently been advocated as discussed below.

The Flat Tax

A flat rate income tax method has been proposed by the current majority leader in the House of Representatives, Richard Armey. A flat tax is one in which the marginal tax rate remains constant as taxable income increases. This constant marginal tax rate persists no matter how high the amount of taxable income.

Armey has proposed a flat 17% rate on all taxable income above the exemption amount. The exemption amount is $12,350 for a single person, $16,200 for head of household, $24,700 for a married couple, along with $5,000 for each dependent of the taxpayer. Therefore, a married couple with two children would not pay tax until taxable income reached $34,700 [$24,700 + ($5,000 * 2)]. Taxable income also only includes income received for services rendered. It does not include interest, dividend, or capital gains income (JCT, 32).

Advantages

According to flat tax proponents, the principal purpose of the flat tax method is to encourage a more productive effort from taxpayers, fostering additional time at work as well as increased capital investment. After-tax earnings would be increased because of the lower marginal rate of 17%. Additionally, savings and investment income would not be taxed, leading to economic growth and a larger stock of capital equipment in the economy.

Taxpayers will be motivated to work harder and invest more with their higher "take home pay".

Another advantage is that the tax system would be simplified. Only earned income is included in gross income, no itemized deductions are allowed, and one tax rate simplifies the tax system.

Lastly, although the marginal tax rate is constant, the average tax rate is progressive. The higher the income, the higher the average tax rate. This is due in part to the loss of itemized deductions. An illustration is given in Table 1 (adapted from Fellows, 20).

Progressivity in a Flat Tax
Married Filing Jointly, No Dependents

Table 1

Income	Exemption	Taxable Income	Tax Liability	Average Tax Rate
$40,000	$24,700	$15,300	$2,601	7%
$50,000	$24,700	$25,300	$4,301	9%
$70,000	$24,700	$45,300	$7,701	11%
$100,000	$24,700	$75,300	$12,801	13%

Disadvantages

The main disadvantage is the loss of itemized deductions for those who can utilize them under the present system. Itemized deductions are a way taxpayers can eliminate part of their income from taxation. Eliminating this option will hurt the higher income taxpayers while not affecting lower-income taxpayers unable to take these deductions under the current system.

Another minor disadvantage is the impact on additional standard deductions for a taxpayer who was either (1) blind, or (2) over the age of 65. This deduction would be lost under the flat tax system.

The Universal Savings Allowance (USA) Tax

Another proposed income tax is called the USA Tax of 1995. Senators Sam Nunn and Pete Domenici introduced the Universal Savings Allowance (USA) Tax to replace the current system. Basically, the "savings-exempt" income tax would tax all income less an unlimited deduction for net new savings. The system would then use a three-tier graduated tax rate schedule.

The savings-exempt tax is a modified version of a personal consumption tax. Borrowing would not be included in income but will reduce the net savings deduction. Thus, a net borrower would not pay tax on an amount greater than his/her income in a given year. The additional consumption would be taxed as the loan is repaid.

The graduated three-tier tax rate structure would change for the first four years from 1996-1999. Beginning with the year 2000 the tax rate schedules would be based on filing status and taxable income. This is illustrated in Table 2 (JCT, 39).

Table 2

If taxable income is:	Tax Liability equals:
	Single individuals
$0-$3,200	8 % of taxable income
$3,200-$14,400	$320 + 19% of amount over $3,200
Over $14,400	$2,560 + 40% of amount over $14,400
	Heads of Households
$0-$4,750	8% of taxable income
$4,750-$21,100	$380 + 19% of amount over $4,750
Over $21,100	$3,486.50 + 40% of amount over $21,100
	Married filing Joint
$0-$5,400	8% of taxable income
$5,400-$24,000	$432 + 19% of amount over $5,400
Over $24,000	$3,966 + 40% of amount over $24,000
	Married filing Separately
$2,700	8% of taxable income
$2,700-$12,000	$216 + 19% of amount over $2,700
Over $12,000	$1,983 + 40% if amount over $12,000

*expressed in 1996 terms: will be adjusted for inflation each year subsequently

The taxpayer would be allowed a deduction for any increases in his/her "net savings" during the year. "Net savings" is a taxpayer's additions to qualified savings assets which are: stocks, bonds, securities, certificates of deposits, interest in proprietorships and partnerships, mutual fund shares, life insurance policies, annuities, retirement accounts and bank, money market, brokerage and other similar money accounts (JCT, 40).

A family living allowance, personal and dependency exemptions are allowed. The personal and dependency exemptions are $2,550 each. The following lists the family allowance (JCT, 40).

Filing Status	Family Living Allowance	Present Deduction
Joint return	$7,400	$6,550
Head of Household	$5,400	$5,750
Married filing separately	$3,700	$3,275
Single	$4,400	$3,900

The USA Tax also provides for itemized deductions in addition to the standard deduction. The current system allows itemized deductions only if they exceed the standard deduction. However, the only itemized deductions allowed under the USA Tax are those for home mortgage interest, charitable contributions, alimony paid and qualified educational expense (limited to $2,000 per eligible student per year and $8,000 in total per year) (JCT, 41).

In addition, certain credits against the amount of taxes due are allowed. These include a foreign income tax credit, payroll tax credit, earned income credit, and a credit for estimated and withholding taxes paid. All other existing credits are disallowed. The remaining taxable income would be subject to the above table for the tax determination (JCT, 41).

Advantages

The first advantage of the USA Tax is its net new savings deduction. The broad base of qualified savings assets aids in preventing double taxation. It also encourages savings, investment and individual planning for future economic benefit (Tritch, 25).

The second advantage is its hefty family living, personal and dependency exemptions. This tax structure will benefit the hard working middle class who struggle with a small living allowance while saving and investing a portion of their income as well.

Disadvantages

The primary disadvantage to the USA Tax is its complexity. Complexity is one of the main reasons for changing the current system. The USA Tax is just as, if not more, complex than the current system.

Another disadvantage is the double taxation of retiree's savings. The savings were taxed when earned and now when the retiree needs to withdraw the money from savings and spend it, the savings will be taxed again (Tritch, 25-26).

Comparison of Income Based Proposals

The proposals attempt to improve the taxation process. Each has its good and bad points. Yet, the two are very different and address different problem areas of the current system.

First of all, the flat tax is a fairly basic system. The USA Tax may increase the complexity problems. Although both structures encourage savings, the USA Tax better provides for the savings exemption. The flat tax simply does not tax earnings on savings and investments while the USA Tax deducts the actual payments into the qualified savings assets. The flat tax method taxes these payments as earned income. The argument for the USA

Tax is that a taxpayer's liquidity is affected by these payments and should not be taxed.

In terms of simplicity, the flat tax is the better method. Yet, in terms of encouragement of savings and investment, increase in economic situation, and ability-to-pay, the USA Tax is superior.

The Consumption Based Method

The consumption based method of taxation is aimed at encouraging savings and investment in an effort to revive the dwindling economy. The view is that people who are able to spend more money have a better ability to pay the tax liability and thus should pay more in taxes.

Economic theory suggests that if the tax rate is reduced, more work and investment will occur (Fellows, 19). Proponents of the consumption tax method say an increase in take-home-pay will have the same effect. The higher take-home-pay will encourage people to save their own money, decreasing the reliability on debt (Lugar, 5). This, in theory, should increase productivity and spur the economy.

A consumption based method is also less intrusive than an income based method. Some people believe that the government invades their privacy by requiring the submission of the amount of income received in each year. By taxing consumption, the government would only be aware of each taxpayer's exemptions claimed (Pechman, 201).

The main problem with using a consumption based method is its effect on lower income families. This impact creates a political flaw in the introduction of such a method. Lower income families must spend a higher percentage of their income for the bare necessities. At the same time, the taxpayers with higher incomes need to spend a lower percentage of their income for the necessities and the rest is for luxury items. Is it fair to tax lower income families on say 80% of their income while taxing higher income families on say 40% of their income? The following discussion reviews two different consumption tax proposals.

National Sales Tax

Senator Richard Lugar proposes to stop working around the edges of the tax code and transform it completely with a national retail sales tax similar to his home state of Indiana's state sales tax. Lugar's argument stems from the issues he views as the results of an income based method such as the current system. These are as follows:

1. diminished economic growth
2. lack in average wage increases
3. double taxation of savings and investment
4. alarmingly low net national savings rate (2-3).

Lugar professes a system with no records to keep and no auditors to fear. Taxes would only be paid on purchases. Savings and investments would be tax free. Also, take-home-pay would be higher since there would be no tax on income.

The National Sales Tax (NST) on goods and services would replace the federal personal and corporate income taxes, capital gains and estate taxes. Economists estimate an NST rate of 17% is necessary to replace the revenue generated by our current tax system (Lugar, 6).

The NST is a tax imposed on the retail sales price to consumers of taxable goods or services. Housing and medicine purchases are the only exemptions under the Lugar plan. Personal and dependency deductions would be allowed at $5,000 each (Lugar, 3).

Advantages

First, an NST would increase take-home-pay which would increase savings and investments. According to a study by economist Laurence Kotlikoff, NST would increase the savings rate from 2% to about 7.6% in the first year (Kotlikoff qtd. in Lugar, 5). This is due in part to its transparency. Each individual would be able to control how much tax he/she will pay through how much he/she will purchase.

In addition, the simplicity of the NST and the absence of an IRS would have the effect of discouraging frequent tinkering with the tax code. Tinkering complicates business activities, leads to loopholes for special interests, and creates uncertainty of taxes owed for many Americans.

Last but certainly not least, an NST would tax drug dealers and other criminals who currently escape or evade the income tax (Lugar, 7). Cash-basis workers would also be forced to pay appropriate taxes on income they more than likely are not reporting under the current system. The income would be taxed when it is spent.

Disadvantages

The NST imposes a tax only at the retail stage of the production and distribution chain. This increases the opportunity for the evasion of the entire tax when the retailer fails to meet its taxpaying duty. The complete tax, however, is evaded only when there is some coordination between parties at different stages of the production and distribution chain.

Another difficulty is defining the retail stage of the process. The designation of persons who would be able to make purchases on a tax-exempt basis from retail outlets also needs to be addressed. For example, a retail sales tax should exempt purchases by other businesses. Tax-exempt identification numbers could be used although their use invites abuse, especially in self-employed and closely held corporations.

Additionally, an NST double taxes social security and retiree savings. This money was taxed when it was earned and will be taxed again when spent under an NST taxation system. It also burdens low income families as discussed above.

Finally, an NST would be visible. Like the VAT, this tax could impact state sales tax levies. A taxpayer is more likely to object to a tax he/she is able to view on his/her purchase receipts. If an NST is implemented on top of a state sales tax, the taxpayer is likely to resist purchasing goods. The first place of attack for businesses is their own state. Pressure could be put on state legislatures to modify the state sales tax levy.

Thus, businesses may need to endure a short recession at the onset of the tax implementation. This can be disastrous for smaller companies, especially if loss carry-forwards are lost. However, in the long-run, businesses should carry on as usual once taxpayers realize the increase in their take-home-pay.

Value-Added Tax (VAT)

A value-added tax (VAT) generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. The amount of value added can be thought of as the difference between the value of sales (outputs) and purchases (inputs) of an enterprise. Thus, the burden of paying the tax is on the consumer in the form of a consumption tax (JCT, 17). It is also similar to a luxury tax in that as the value increases, the tax being levied increases.

This study will apply the use of the credit invoice method of enforcing the VAT. This has been the method of choice in nearly all countries who have adopted a VAT. The VAT is imposed on the seller on the basis of total sales. All purchases of taxable goods and services by a business are allotted a business credit. The net tax paid is based on the value added at that stage of production. In theory, the amount of tax paid should equal the sales price to the consumer times the VAT rate. The ultimate consumer does not receive a credit.

There are some exclusions allowed. First, special treatment is given to imported and exported goods. Second, certain goods and services, or classes of taxpayers may be excluded from a VAT either by providing a "zero rating" or an exemption.

Certain goods and services are excluded as a result of the difficulty in measuring the value added or the element of consumption with respect to the good or service. A zero rating at the retail level relieves all the VAT collected at all prior stages and results in no tax levy. If the zero rating is implemented at any other stage of production, the result would be a total tax as if no exclusion were allowed.

For example, Table 3 gives an analysis of a zero rating being implemented at the different stages in the production of a wool sweater (adapted from JCT, 24).

Table 3 Zero rating for:

	No one	Sheep farmer	Knitter	Retailer
Retailer	25-15= 10	25-15= 10	25-0= 25	0-15=(15)
Total VAT	25	25	25	0

The other alternative is to provide for a exemption at various stages of production. Table 4 illustrates this method (adapted from JCT, 24).

Table 4 Exemption for:

	No One	Sheep farmer	Knitter	Retailer
Sheep farmer	8-0= 8	Exempt	8-0= 8	8-0= 8
Knitter	15-8= 7	15-0= 15	Exempt	15-0= 15
Retailer	25-15= 10	25-15= 10	25-0= 25	Exempt
Total VAT	25	25	33	23

Thus, a system providing an exemption at a particular stage will only relieve the amount of tax that would have been added at that particular stage.. The tax from the other stages must still be levied.

Advantages

A major advantage of the VAT is its treatment of imports and exports. Exported goods would receive a zero rating creating a refund of taxes paid for purchases for that company. Also, the imports would be taxed on the full value of the good or service. This system favors American made goods, and is detrimental to foreign made goods.

Another advantage is the VAT's relationship to a luxury tax. A luxury tax aids in shifting the tax burden to high priced items consumed by the wealthy. The lower priced goods consumed by the poor would have a lower tax burden.

Disadvantages

The main disadvantage is its intrusion into state and local sales taxes. The imposition of a federal VAT would have a direct effect on the state revenues. The VAT is also very complex. The transition to the VAT system has many downfalls. This is exemplified by the problems Great Britain encountered during its VAT implementation.

Another aspect of the VAT that is disadvantageous is its visibility. The sales to other businesses must disclose the amount of VAT imposed for refund purposes. However, consumer sales do not require the segregation. Therefore, consumers will not be aware of how much tax they are paying. It is hidden in the regular price of the item.

Comparison of Consumption Based Methods

In an effort to simplify the tax system, the NST should be implemented. The only compliance burden on individuals would be to file for a return of the exemption amounts allowed. The VAT is very complex and may require specialists to determine the value added at the particular stages of production.

Both consumption based methods put the compliance burden on the businesses. The individuals would automatically pay the tax at the point of sale. Each business would be required to decipher what amount of revenue was actually taxed and would be responsible for compensating the government. This would prove to be an expensive burden on small businesses.

However, in terms of equity, the VAT system is superior. In its resemblance to a luxury tax, the VAT taxes individuals with the means to purchase high priced items. If a person has the ability and willingness to purchase these items he/she must also pay the tax.

Conclusion

The present tax system has been proven ineffective. A major result has been a negative effect on the economy. If we examine how a large portion of society finances its activities we can see this effect. Many individuals in the U.S. rely heavily upon debt as a means of finance. The problem intensifies as interest rates worsen as they have in the past couple of years. People are finding it harder and harder to get out of debt. They can no longer receive a return on capital investment in excess of their borrowed rate. This trend is detrimental to the standard of living as presented by Senator Lugar in the above discussion.

Another problem is the over reliance on social security. At the original implementation, the social security system was meant to be used as supplemental income. Many people receiving these payments now rely on them as major sources of income. Economists say this is partially a result of the discouragement of savings and investment by the income tax system. If the tax system encourages people to save, they will not have to rely as heavily on the social security system. Thus, the standard of living after retirement age will increase.

All four proposals outlined above encourage savings. The question then is which method best serves all members involved? The answer is not so clear-cut. If the main priority is simplification, the NST or flat tax would be preferred. If the main priority is ability-to-pay, the VAT is preferred. However, if aiding individuals who spend and save/invest simultaneously is the main priority, the USA Tax is best.

Once it is established which priority takes precedence over the others, the appropriate method can be chosen. The fact that precedence is highly debated and a consensus not reached has resulted in Congress not changing the current system thus far for 1996. Until the United States Senate establishes its priorities on taxation, a change will not occur.

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